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October 29, 2004

VIA ELECTRONIC FILING

Ms. Marlene H. Dortch
Secretary
Federal Communications Commission
445 Twelfth Street, S.W.
Room TWB-204
Washington, D.C. 20554

RE: NOTICE OF EX-PARTE COMMUNICATION

In the Matter of Section 272(f)(1) Sunset of BOC Separate Affiliate and Related Requirements, WC Docket No. 02-112

Dear Ms. Dortch:

SBC Communications Inc. hereby submits the attached white paper that responds to arguments raised by AT&T in various *ex parte* filings in the above referenced proceeding.

In accordance with section 1.1206 of the Commission's rules, this letter is being filed in the above referenced proceeding via the Commission's ECFS system. Should you have any questions regarding the attached, please do not hesitate to contact me by whatever means are most convenient for you.

Sincerely,

A handwritten signature in blue ink that reads "Brett A. Kissel". The signature is written in a cursive, flowing style.

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Regulation of Long Distance Services is Unnecessary And Would Harm Consumers

In recent months, AT&T has filed a blizzard of ex partes in which it purports to demonstrate that the BOCs are dominant in the provision of long distance services. AT&T's many pages of filings do not contain *any* credible argument that intervention by the Commission is necessary to protect consumers from higher prices. To the contrary, AT&T's entire focus is on preventing *lower* prices. The Commission has never before imposed dominant carrier regulation to prevent price reductions, and for good reason: it recognizes the difference between promoting competition and protecting the interests of individual competitors that attempt to use regulation as a shield against competition. AT&T here seeks insulation against competition, hiding its agenda behind a pro-competitive facade that has no basis in law, economics, or fact.

As an initial matter, AT&T never disputes that the long-distance marketplace today is *intensely* competitive and that consumers are reaping enormous benefits from this fierce competition through unprecedented choices and rates that are at record-low levels. Nor does it dispute that, due to competition from, *inter alia*, interexchange carriers, CLECs, wireless carriers, cable telephony providers, providers of Voice over Internet Protocol (VoIP), and from the Internet itself as an alternative mode of communication, there is vastly more competition for long distance communications than when AT&T itself was declared non-dominant in 1995. See *Comments of SBC Communications Inc.*, June 30, 2003, at 8-37. Nor, even, does AT&T dispute that it is the largest current provider of long distance services in this vigorously competitive market.

Apparently recognizing that it cannot prove market power on any conventional basis, AT&T instead resorts to two desperate strategies. First, it claims that, even though the BOCs do not have market power today, they should be regulated as dominant because they might acquire market power at some unspecified point in the future by effecting a price squeeze. These arguments are addressed in detail in SBC's Reply and in the Declaration of William E. Taylor *et al.*, filed August 10, 2004, at 13-22. Suffice it to say here that AT&T's price squeeze arguments have been repudiated by economists, this Commission, and the Supreme Court of the United States, and for good reason. As this Commission has found, "firms in dynamic industries such as telecommunications generally do not have the incentives to engage in predatory practices, because the success of such practices rests on a series of speculative assumptions." *In re Applications for Consent to the Transfer of Control of Licenses and Section 214 Authorizations from Tele-Communications, Inc. to AT&T Corp.*, 14 FCC Rcd 3160, at ¶ 118 n.327 (1999) (citing *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 588-98 (1986)).

Indeed, these assumptions, as applied to the long-distance market, are not merely speculative, but irrational. To accept AT&T's theory, the Commission would have to conclude that, notwithstanding the intense intermodal and intramodal competition in the long-distance market, and notwithstanding that BOC access is, among other things, subject to competition and regulatory oversight (including the pendency of intercarrier compensation reform), predation or a price squeeze would enable the BOCs to eliminate all long distance competition, *including their intermodal competitors who do not even rely on BOC access for their services*. Moreover, the Commission would have to conclude that, having driven all of their competitors from the market, the BOCs could then recoup their lost profits by raising and maintaining long distance rates at supracompetitive levels, without attracting new entry into the market or triggering rate regulation as a result of their new monopoly status. And, the Commission would have to assume that the

BOCs could effect this violation of the antitrust laws in the dark of night, without regulators or antitrust authorities taking notice, either on their own or at the prompting of adversely affected competitors. Quite obviously, this chain of events could never realistically occur and, therefore, no BOC would ever attempt such a doomed course of action. Yet, in the wildly improbable event that a successful price squeeze did take place, the Commission could always impose dominant carrier regulation or other remedies at that time. AT&T's Alice in Wonderland theory thus provides no basis for imposing dominant carrier regulation today.

AT&T's second strategy is to gerrymander a phony "product market" of bundled local and long distance services under the theory that it might have more luck arguing that the BOCs are dominant in that imagined "market." That approach, as well, is unsupportable on both the facts and the law. It rests on a myopic and misleading depiction of today's marketplace for long distance and other communications services and a completely erroneous application of antitrust principles regarding "cluster markets" and "submarkets."

More fundamentally, while AT&T's proposed market definition is unsustainable even as a snapshot in time, it is doubly flawed insofar as it ignores the rapid pace at which change is sweeping the telecommunications landscape. Although it is certainly true that many – though, by no means all – consumers seek bundled packages of services, the nature of those bundles and the manner in which they are delivered is continually evolving. The communications industry is in the midst of an era of unparalleled dynamism and competitiveness that derives not from the section 272 structural separation requirements, but rather from the increasingly fierce battle for survival now underway among wireline, wireless, cable telephony, and VoIP providers as a result of technological innovation and convergence. AT&T would have the Commission ignore these realities and rely instead on a view of the market that is static, backward-looking, and blind to technological innovation. In effect, AT&T is asking the Commission to assume that: the way customers use communications will not continue to evolve; the way providers deliver communications will not continue to evolve; the types of communications services that providers deliver to customers will not continue to evolve; and the providers of communications services themselves will not continue to evolve. The Commission should affirmatively reject this Luddite view of the communications marketplace and instead recognize the imperative – and the opportunity – to evaluate this increasingly converged communications marketplace in a manner that is dynamic, forward-looking and that takes account of innovation. A realistic view of this market will enable the Commission to move forward appropriately to establish a deregulatory framework that accounts for not only the intense competition that exists today, but the transformational changes that are on the immediate horizon.

Numerous Demand and Supply Substitutes Either Exist or Are on The Verge of Deployment that Constrain the Price of Wireline Long Distance Services. The days in which "long distance" meant only traditional wireline communications services are over. To be sure, there are numerous providers competing to sell such services to consumers, and those providers by themselves demonstrate the competitiveness of this market. Declaration of William E. Taylor et al., *supra*, at 11-12. But the providers of such services make up only a few of the numerous choices available to consumers for long distance service. Other options abound.

First, wireless providers compete vigorously for consumers' long distance business. One recent report concluded that "use of wireless phones has dramatically impacted wireline long

distance usage” as “long distance accounted for nearly 40 percent of wireless calls” and “consumers that use wireless phones have significantly decreased their wireline phone usage for BOTH local and long distance services.” In-Stat/MDR, *Into Thin Air: Residential Wireline Erosion from Wireless and Other Access Alternatives*, June 2004, at 16, 20. Indeed, wireline long distance minutes have declined 40 percent over the past five years,¹ and the Yankee Group has estimated that U.S. households now make 43 percent of their long distance calls on wireless phones.²

Second, switched cable telephony services provide another option for many consumers. Switched cable telephony is currently available to 15 percent of U.S. households, and cable companies have had impressive success in marketing these services in the areas in which they are available.³

Third, voice over Internet protocol (VoIP) service is poised to revolutionize, not only the long distance market, but the local market as well. Powered by packet switches that the Commission has recognized are ubiquitous,⁴ VoIP is available to more than 90% of U.S. households.⁵ Moreover, the quality issues that previously depressed consumer acceptance of VoIP are a thing of the past, yet prices are up to 30% lower. Perhaps most important is that the start-up costs necessary to provide VoIP are astonishingly low. One prominent wholesaler “charges \$25,000 for a basic set of services needed to start an Internet phone business.” Ken Brown & Almar Latour, *Heavy Toll: Phone Industry Faces Upheaval As Ways of Calling Change Fast*, Wall St. J., Aug. 25, 2004, at A1. As explained by the founder of one IP-based provider – which started service last year and turned cash flow positive earlier this year – “[i]t’s unbelievable how much we can offer for such a small investment.” *Id.* (quoting Bob Paulsen, Unity co-founder and president).

Chairman Powell has recognized the revolutionary nature of VoIP:

[I]n recent months, one application has grabbed headlines: Internet voice services. These applications have garnered a great deal of attention because they allow voice communication among users,

¹ Industry Analysis & Technology Division, Wireline Competition Bureau, *Statistics of the Long Distance Telecommunications Industry*, May 2003, at Table 20.

² Yankee Group News Release, *U.S. Consumer Long Distance Calling Is Increasingly Wireless*, Mar. 23, 2004, at http://www.yankeegroup.com/public/news_releases/news_release_detail.jsp?ID=PressReleases/news_03232004_cts_2.htm.

³ Declaration of William E. Taylor et al., *supra*, at 39 & n.77.

⁴ *Report and Order and Order on Remand and Further Notice of Proposed Rulemaking, Review of the Section 251 Unbundling Obligations of Incumbent Local Exchange Carriers*, 18 FCC Rcd 16978,), ¶¶ 537-38 (2003) (*Triennial Review Order*), vacated in part and remanded, *United States Telecom Ass’n v. FCC*, 359 F.3d 554 (D.C. Cir. 2004), petitions for cert. denied, *NARUC v. United States Telecom Ass’n*, Nos. 04-12, 04-15 & 04-18 (U.S. Oct. 12, 2004..

⁵ *UNE Fact Report 2004*, Submitted October 2004 in WC Docket No. 04-313 and CC docket No. 01-338 at I-2.

much like traditional wired or wireless voice networks. * * * When packetized, voice applications are virtually identical to any other Internet application, such as email or instant messaging. Consequently, would-be entrepreneurs are just a website and a server away from offering services that mirror those of a "phone" company. And suddenly every consumer with broadband access can choose among potentially hundreds of voice over Internet service providers.

Written Statement of Michael K. Powell on VoIP, Feb. 24, 2004, at i-ii.

AT&T also has recognized the revolutionary nature of VoIP. Indeed, its Chairman has called VoIP "the most significant, fundamental new technology shift in telecommunications in decades." Shawn Young, *AT&T To Launch Internet-Based Telephone Service*, Wall St. J., Dec. 11, 2003, at B6. Likewise, the President of AT&T Labs, Hossein Eslambolchi, has stated that the Internet programming language at the heart of VoIP "is like Pac-Man * * * [e]ventually it will eat everything in its way." Peter Grant & Almar Latour, *Circuit Breaker: Battered Telecoms Face New Challenge: Internet Calling*, Wall St. J., Oct. 9, 2003, at A1. Most importantly, AT&T's Chairman has acknowledged that VoIP is a substitute for wireline communications: "Now that we can see that the technology has advanced itself, VoIP is coming into its own. *It's a viable substitute for wired-line telephony*, especially in a world where wireless is available as a back-up." Dawn Kawamoto & Ben Charny, *AT&T Chief Refuses To "Miss" VoIP*, CNET News.Com, Aug. 30, 2004 (emphasis added).

AT&T has announced that it is focusing its growth efforts on "emerging technologies, such as [VoIP], that can serve businesses as well as consumers."⁶ Its CallVantage offering (with a \$19.99 introductory price for unlimited local and long distance calling and other advanced features) is widely available – in "39 states and Washington, D.C. – that's 121 major markets" – and AT&T expects 1 million business and consumer users by the end of 2005.⁷ AT&T is aggressively marketing this service – spending \$25 million on advertising during the recent Olympic Games (in addition to direct mail and on-line advertising) – and partnering with retailers such as Best Buy and Amazon.com. "AT&T said that subscribers signed up in record numbers after the first ads ran. Subscriptions also doubled the following week, the company said, compared with the week before the Olympics." Ken Belson, *AT&T Uses Its Long Past To*

⁶ AT&T Press Release, *AT&T Announces Second-Quarter 2004 Earnings, Company To Stop Investing in Traditional Consumer Services; Concentrate Efforts on Business Markets*, July 22, 2004, at <http://www.att.com/news/item/0,1847,13163,00.html>.

⁷ AT&T News Release, *AT&T CallVantage Service Expands to 21 New Markets in Seven States in Nationwide Deployment*, Aug., 19, 2004, at <http://att.com/news/item/0,1847,13211,00.html>; see also AT&T News Release, *AT&T CallVantage Service Now Available in 100 Major Markets: Coast-to-Coast Rollout Expands to 28 New Markets and Seven Additional States. \$19.99 Promotion Offers Unlimited Calling and Advanced Features*, July 12, 2004, at <http://att.com/news/item/0,1847,13134,00.html>.

Promote Its Near Future, N.Y. Times, Aug. 28, 2004, at B14. The company also is “teaming up with cable companies nationwide” to promote its service.⁸

Numerous other companies are offering VoIP services. “Vonage has signed up nearly 250,000 paying telephone customers in two years” and, according to its CEO, plans to become “a national local and long-distance player.” Ken Brown & Almar Latour, *Heavy Toll: Phone Industry Faces Upheaval As Ways of Calling Change Fast*, Wall St. J., Aug. 25, 2004, at A1. Another competitor, Skype, handles roughly 1.2 million calls a day. *Id.* Covad has announced that it is selling VoIP services to customers in 42 cities. Jim Hu, *Covad Adds New Line — VoIP*, CNET News.com, Aug. 12, 2004. And now, even the largest Internet Service Providers (ISPs), such as AOL, with tens of millions of established customer relationships are throwing their hats into the VoIP ring. See Jim Hu & Ben Charny, *AOL Testing Net Phone Service*, CNET News.Com, Aug. 30, 2004 (“AOL’s entry into Internet telephony underscores a rush among many giants in the technology and telecommunications industries to offer the service. That’s because VoIP is less expensive for providers to operate, resulting in a lower monthly bill for consumers and businesses.”).

“Anyone who wants to go into the phone business can do it,” explained the CEO of 8x8 Inc., which offers VoIP services under the Packet8 brand. Brown & Latour, *Heavy Toll*, *supra*. “Entrepreneurs who want to start a Vonage-like phone company can get access to software, ready-made Web sites and fiber-optic networks from wholesalers such as Covad Communications Group Inc.” for \$25,000. *Id.*; see also Shawn Young, *A Price War Hits Internet Calling*, Wall St. J., Aug. 26, 2004, at D1 (describing competition among VoIP providers).

Cable providers will be particularly aggressive competitors, as they already are poised to rollout VoIP services on a widespread basis. Each of the six major cable operators – which together reach 85% of U.S. households – has either begun commercial deployment of IP-based telephony service or announced plans to do so imminently.⁹ And these companies are fierce competitors: They have a proven track record of success in offering local voice to customers, and in areas in which they have begun to offer IP-based services to customers, they already have won significant market share. “In just over a year, one out of every eight households in the Portland, Maine, region has signed up for Internet phone service supplied by Time Warner Inc.’s cable-television unit.” Brown & Latour, *Heavy Toll*, *supra*. Cablevision signed up 115,000 home subscribers in just over seven months in New York, and it boasts 3,400 additional new adds every week in that same region. Brown & Latour, *Heavy Toll*, *supra*; see also Affidavit of David L. Teitzel, *Petition of Qwest Corporation for Forbearance Pursuant to 42 U.S.C. § 160(c) in the Omaha Metropolitan Statistical Area*, June 21, 2004, at 10-12 (stating that in Cox’s mature markets, one in three homes subscribe to its cable telephony service and discussing Cox’s penetration of the Omaha market).

⁸ Almar Latour, *AT&T, Cable Providers Join Forces: Internet-Phone Customers Will Get Broadband Deals, In a Challenge to the Bells*, Wall St. J., Aug. 19, 2004, at B4; see also AT&T News Release, *AT&T To Offer AT&T CallVantage Service with Adelphia High-Speed Internet Access*, Aug. 19, 2004, at <http://att.com/news/item/0,1847,13225,00.html>.

⁹ *Fact Report 2004* at II-6.

Moreover, additional methods of delivering broadband services – and VoIP – such as Broadband over Power Line (BPL) and WiMax are just on the horizon. See, e.g., FCC Chairman Powell: The Future is Bright for Powerline Broadband (July 14, 2004) (“Powerline technology holds the great promise to bring high-speed Internet access to every power outlet in America. What I saw today has the potential to play a key role in meeting our goals to expand the availability and affordability of broadband.”); see also Brown & Latour, *Heavy Toll*, *supra* (discussing use of WiFi and WiMax technology to provide broadband access for VoIP services).

Fourth, various forms of data communications (such as e-mail and instant messaging) increasingly are used by consumers as substitutes for long-distance voice communications. A 2002 J.D. Power and Associates study found that 92 percent of U.S. dial-up Internet subscribers are replacing long distance calls with e-mail.¹⁰ Nationwide, e-mail, instant messaging and VoIP have resulted in a 47 percent reduction in long distance usage among Internet subscribers.¹¹

AT&T, of course, does not and could not dispute that wireless service and VoIP are winning minutes away from wireline long distance and that various forms of data communications (such as e-mail and instant messaging) can substitute for voice communications. It instead advances a number of spurious legal arguments in trying to block consideration of these obvious substitutes.

With respect to wireless, AT&T contends that it is not “fully substitutable” for wireline and therefore may not be considered. But this argument ignores the indisputable fact – supported by the In-Stat/MDR study discussed above – that consumers can and do shift long distance minutes from wireline to wireless. See also *In re Applications of AT&T Wireless Services, Inc. & Cingular Wireless Corp.*, FCC 04-25 at ¶ 74 n.267 (Oct. 26, 2004) (“some consumers may find wireless services to be a good substitute for wireline service”). Whether or not a consumer would be willing to shift *all* of his or her communications to wireless is therefore totally beside the point (although this *is* occurring, albeit at a more gradual pace): Wireless calling plainly now is displacing wireline long distance calling on a significant basis. Indeed, AT&T itself has expressly recognized this phenomenon: “Stand-alone long distance voice services revenue has continued to decline due to competition and technology substitution (customers using wireless or Internet services in lieu of a wireline call).” AT&T 2003 Annual Report, at 4.¹² Wireless services thus act as a competitive constraint on wireline services.

It is a settled principle of antitrust law that another medium of communication need not be a “full” substitute to be considered part of the same product market. “Competitors need not provide a perfectly undifferentiated product in order to be competitive; it is a strength of our free market economy that competitors often provide products that cater to the varied tastes and preferences of consumers.” *United States v. Syufy Enter.*, 903 F.2d 659, 669 n.15 (9th Cir. 1990)

¹⁰ J.D. Power and Associates, *2002 Syndicated Residential and Internet Customers Satisfaction Study*, Aug. 2002.

¹¹ *Id.*

¹² As we discuss below, there is *also* a separate – and growing – trend of complete replacement of wireline by wireless, as consumers increasingly are deciding to use a wireless phone as their only phone. See *infra* page 13.

(Kozinski, J.). Only “reasonable interchangeability” of the products is necessary. *United States v. E.I. du Pont de Nemours & Co.*, 351 U.S. 377, 404 (1956);¹³ cf. *Satellite Television & Associated Res., Inc. v. Continental Cablevision of Va., Inc.*, 714 F.2d 351, 355 (4th Cir. 1983) (concluding that cable television, satellite television, video cassette recordings, and free over-the-air television are all reasonably interchangeable by consumers and therefore in the same relevant product market); *America Online, Inc. v. GreatDeals.Net*, 49 F. Supp. 2d 851 (E.D. Va. 1999) (suggesting that relevant advertising market included advertising on e-mail, WWW, direct mail, billboards, television, newspapers, and radio). Wireless long distance plainly satisfies this test. In approving the merger, this Commission recognized as much. *In re Applications of AT&T Wireless Services*, *supra*, at ¶ 74 n.267 (“Customers of mobile telephony services are unlikely to find wireline services to be close substitutes because wireline services lack the mobility dimension of wireless services. However, some consumers may find wireless services to be a good substitute for wireline service.”).

AT&T’s claims on pages 10-11 of its June 28, 2004 *ex parte* about statements in filings related to the Cingular-AT&T Wireless merger are similarly incorrect. The statement AT&T quotes refers to the substitutability of wireline for wireless; it did not address the converse relationship – whether wireless long distance is a substitute for wireline long distance. Indeed, in the very same merger proceeding the parties recognized that such substitution takes place, stating “the intense competition and rapid growth in wireless voice services has led to a degree of substitution of wireless minutes for wireline minutes. This transaction will not retard the trend towards convergence between wireless and wireline communications.” *In re AT&T Wireless Services, Inc. and Cingular Wireless Corp., Application for Transfer of Control*, WT Docket No. 04-70, Mar. 18, 2004, Exhibit 1, at 43. AT&T’s attempted mischaracterization of the position is downright deceptive.¹⁴

With respect to VoIP and cable telephony, AT&T is again wrong as a matter of law in asserting that the current relatively small market share of these services renders them irrelevant to the dominance inquiry. Where there is the potential for “committed entry” – entry involving

¹³ See Andrew I. Gavil, William E. Kovacic & Jonathan B. Baker, *Antitrust Law in Perspective* 474 (2002) (describing how the “Guidelines’ focus on demand substitution as the basis for market definition is consistent with the Supreme Court’s doctrinal formulation in *Cellophane* that products markets are collections of goods with ‘reasonable interchangeability’ in demand”).

¹⁴ Professor Gilbert, whose affidavit was cited by AT&T, amplified the point discussed in the text: “The [proposed] merger is also very unlikely to raise prices by reducing inter-modal competition between wireline and wireless. * * * Because mobile wireless competition is national in scope, the merged company is unlikely to raise wireless prices only in its [sic] parents’ wireline service territories. If it attempted to do so, given the competitive wireless market, it could not stop or slow wireline to wireless substitution. It would simply lose share, as other wireless carriers would be eager to take the business.” Declaration of Richard J. Gilbert, filed Mar. 18, 2004, at 32. AT&T has thus completely mischaracterized these filings: Rather than arguing against wireless as a substitute for wireline, the pleadings emphatically endorse that position. They also answer the meritless contention that wireless competition is somehow adversely affected because of the affiliation of BOCs with certain wireless providers – the competitiveness of the wireless market, and the national character of that market – ensures vigorous competition from wireless providers. Indeed, 98% of Americans have a choice of three or more mobile wireless providers and 83% have a choice of five or more providers. *Consumer Code: Questions and Answers*, at http://files.ctia.org/pdf/Media_Kit_Q&A.pdf.

sunk costs¹⁵ – the ultimate issue under the merger guidelines is not whether a firm would have the ability to impose a small-but-substantial-nontransitory-increase-in-price (SSNIP) but whether the anticompetitive concern posed by that SSNIP would be alleviated by *two years from the time that supracompetitive prices began*. See 1992 Horizontal Merger Guidelines §§ 3.2-3.4 (describing the “timely, likely, and sufficient” test);¹⁶ cf. *Syufy Enter.*, 903 F.2d at 663 (explaining how under the antitrust laws, “a court ought to exercise extreme caution” before intervening in a “situation where market forces are likely to cure the perceived problem within a reasonable period of time” because that intervention “can itself upset the balance of market forces, bringing about the very ills the antitrust laws were meant to prevent”) (citing Ronald Coase, *The Firm, The Market, and the Law* 117-19 (1988), and Richard Posner, *Economic Analysis of Law* 324-25, 338-39 (3d ed. 1986)).

When analyzing whether or not committed entry is “timely, likely, and sufficient” within the meaning of the merger guidelines, it therefore is important to consider not just those firms that could produce the *same* product *but also* firms that could produce *current (and predicted future) demand substitutes*. In other words, what dictates future competitive effect is not present substitution patterns but future substitution patterns, and the product that helps the market “self-correct” within the two years from when supracompetitive prices were imposed need not be currently positioned to do so as long as it will be by the *end* of that period.

To put the point more concretely, the Commission’s analysis in this case is not limited to the provision of long distance services *per se* but also must include any form of voice or data communications that will be an adequate substitute *within the two years from when supracompetitive prices begin*. The issue before the Commission thus is not to ascertain whether wireless, VoIP, cable telephony, email, instant messaging, and any other form of point-to-point

¹⁵ The guidelines distinguish between “uncommitted entry” and “committed entry.” “Uncommitted entry is hit-and-run. Uncommitted entrants are firms that (1) can enter quickly (within one year) and (2) do so with little in the way of unrecoverable or ‘sunk’ costs * * *. They take advantage of any short-run profit opportunities that anticompetitive behavior by incumbent firms might offer, and leave the market rapidly and inexpensively if those opportunities disappear.” Gavil, Kovacic & Baker, at 537. The merger guidelines consider these entrants as participating in the market and thus adjusts market shares of firms already in the market to account for their hit-and-run capability. *Id.* at 479-80; Guidelines §§ 1.32, 1.41. “In contrast, committed entrants are in for the long haul. Once they enter a market, they expect to stay, because to abandon the market would mean walking away from a substantial sunk investment.” Gavil, Kovacic & Baker, at 537. The Guidelines consider the presence of committed entry at the rebuttal stage when ascertaining whether any anticompetitive problems looming on the horizon are likely to be deterred *or* counteracted in a two-year period of time. *Id.*

¹⁶ “Committed entry” is considered timely if it would have significant market impact within two years from when supracompetitive prices were charged; it generally is considered likely if the potential entrant expects to gain 5% of the market; it is considered “sufficient” if it is large enough in magnitude, character, and scope to solve the competitive problem. See Guidelines §§ 3.2-3.4. See generally Avishalom Tor, *The Fable of Entry: Bounded Rationality, Market Discipline, and Legal Policy*, 101 Mich. L. Rev. 482, 557 (2002) (“When determining post-merger market power, however, the Guidelines state that as long as sufficient entry would likely occur within two years from the date the merged firm were to begin charging supra-competitive prices, the merger will not be banned.”). Indeed, even prior to the 1992 Merger Guidelines, it had been accepted that entry need not be “quick and effective” to constrain the exercise of market power. See, e.g., *United States v. Baker Hughes Inc.*, 908 F.2d 981 (D.C. Cir. 1990).

communications are sufficiently well developed as to be able to substitute for all long distance communications today, but whether they will be able to do so years from now, especially in light of the incentives for investment and deployment of these alternative technologies that a rise in the price of long distance services would provide. Given the ongoing rapid expansion – and soon-to-be wide availability – of this Internet and cable technology, it is inconceivable that any BOC would be able to impose and maintain a supracompetitive price for long distance services for the specified period.

The Existence Of “Bundles” Does Nothing To Change The Analysis. Apparently recognizing that it cannot prove dominance in the long distance market, AT&T focuses its attention on a market of its own devising, gerrymandered to reach the market share numbers that AT&T believes necessary to prove dominance.

Pointing to the fact that consumers sometimes prefer to purchase services in bundles, AT&T argues that there is a separate market for one particular type of bundled offering – bundled local and long distance wireline service – and that SBC and the other BOCs are dominant in that market. This manufactured market provides no basis for imposing dominance regulation on SBC or the other BOCs.

As a threshold matter, AT&T’s argument is quite disingenuous in ignoring the fact that bundles of local and long distance services do not exist in isolation. Suppliers offer many different types of bundles that include these two services: local, long distance, and broadband; local, long distance, and dial-up Internet; local, long distance, and wireless; local, long distance, Internet access, and video; as well as local and long distance alone.¹⁷ AT&T itself offers a number of different bundles.¹⁸ AT&T never explains whether it is arguing that the appropriate submarket encompasses bundles offering only local and long distance or all bundles that include local and long distance. The latter makes no sense even on AT&T’s own terms – why should bundles that compete with local and long distance be excluded from a “bundle” submarket simply because other products are included in the bundle. Surely even AT&T could not contend that these broader bundles do not compete with a bundle of local and long distance alone, especially at the same time that it offers consumers different product bundle permutations.

But if AT&T is arguing – as it must – for a broader “bundle” submarket, difficult issues arise involving comparisons of price (see *infra* pages 11-12). And, more fundamentally, if bundles including other products compete with local/long distance bundles, how can AT&T seriously assert that stand-alone long distance service as well as stand-alone local service is not also in the market.

¹⁷ Declaration of William E. Taylor et al., *supra*, at 24-27 & 40-41.

¹⁸ See <http://www.consumer.att.com/plans/bundles>. Although these bundles do not include wireless, AT&T recently announced an agreement with Sprint to resell wireless services. See Kenneth N. Gilpin, *AT&T in Deal To Return to Wireless Market*, N.Y. Times, May 18, 2004. See also Shawn Young, *All in One: Buying Bundles of Telecom Services Can Make Things Easier and Cheaper for Consumers; The Trick Is Picking the Right Bundle*, Wall St. J., Sept. 13, 2004 at R6 (“AT&T has raised monthly minimums, surcharges or billing fees on numerous calling plans that aren’t packaged with other services”).

Moreover, AT&T's entire argument rests on a basic legal error – it seems to believe that it may avoid any consideration of the substitutes we have just discussed (principally wireless, VoIP, and cable telephony) simply by declaring the existence of a “cluster market” or a “submarket.” That contention is just plain wrong. Putting aside the fact that the sale of bundled communications offerings is still a relatively new phenomenon and that, both within each provider and between providers, the bundles themselves vary greatly and appear to be evolving rapidly, AT&T cannot demonstrate that SBC is dominant in any properly-defined market.

Cluster Market Analysis Is Inappropriate Here. AT&T maintains at page 3 of its June 28 *ex parte* that “[l]ongstanding antitrust precedent supports ‘cluster markets’ of complementary products purchased from a single supplier.” For support, it points to customer demand for one-stop shopping and cost savings that result from offering bundles. But neither of these facts suffice to make “cluster market” analysis appropriate.

“Cluster market” analysis is a tool of analytical convenience that courts use to streamline the adjudication of certain antitrust disputes. It refers to the process whereby courts assign a firm a “cluster market share” that equals the average of the firm’s market shares for each of the individual products that are grouped together in the cluster. Ian Ayres, *Rationalizing Antitrust Cluster Markets*, 95 Yale L.J. 109, 123 (1985). This analysis is appropriate *only* when “(1) most customers would be willing to pay monopoly prices for the convenience of receiving the defendant’s grouping of products, *or* (2) economies of joint provision (economies of scope) make distribution of the cluster cheaper per good than distribution of each separately, *and* (3) the firms supplying one of the products in the cluster could not easily add the others as well.” Phillip E. Areeda & Herbert Hovenkamp, *Antitrust Law*, § 565c at 332 (2002) (citing Ayres, *supra*) (emphasis in original; footnote omitted). “[P]rovided these limits are strictly adhered to,” “[c]lustering nonsubstitutable goods is occasionally useful and simplifies litigation.” *Id.*

Where “these limits are [not] strictly adhered to,” cluster market share will likely be misleading as to actual competitive effect. *Id.* Therefore, as courts and commentators have recognized: “*Most fundamentally, goods cannot be clustered unless there is a sufficient basis for inferring that the defendant has the required degree of market power over each of the goods in the cluster.*” *Id.* (emphasis added); see also *id.* (“Whenever the Supreme Court did approve the clustering of noninterchangeable goods into a single market for administrative purposes, it was because there was no good reason for doubting that the defendant had the same degree of dominance with respect to all the goods in the cluster.”)

Thus, contrary to AT&T’s claims, the mere fact that some consumers may purchase products in a bundle does not make cluster analysis appropriate – the proponent of such analysis must show that the provider exercises market power over *each* of the individual products in the bundle (or cluster). That means AT&T must show that SBC and the other BOCs are dominant in the long distance market, a showing that – as we have just explained – AT&T cannot make.

Indeed, as Professor Ayres presciently noted, “plaintiffs may unjustly propose a cluster market to exclude from the market definition partial cluster producers that are, in fact, competing with the defendant’s individual products. Such inappropriate exclusion of partial cluster producers can overstate dramatically a defendant’s market share” and lead to improper outcomes. Ayres, *supra*, at 124; see also Jonathan B. Baker, *The Antitrust Analysis of Hospital*

Mergers and the Transformation of the Hospital Industry, 51 Law & Contemp. Probs. 93, 123-140 (1988) (discussing how “the pragmatic justification for cluster markets breaks down when some firms successfully compete with a partial line of services”). That is precisely why AT&T seeks to use cluster market analysis here.

The existence of cost savings in connection with the purchase of bundles, and consequent customer demand for them, is hardly novel or surprising. Any firm offering a bundle in virtually any business can price it below the standalone price for the goods or services because of the low customer churn and other economies of scope that comes from packaging multiple products and augmenting customer convenience. Just as with any good, demand rises as price falls.

But those facts do not make clustering any more appropriate. “[E]ven though economies of scope cause joint supply, they do not justify clustering.” Ayres, *supra*, at 118; see also Areeda & Hovenkamp, *supra*, § 565c (economies of scope alone are insufficient to justify clustering). Put simply, clustering is not a means by which AT&T may avoid competing with legitimate low prices.¹⁹

Submarket Analysis Does Not Eliminate The Need To Consider Substitutes For Wireline Long Distance. AT&T also claims that “submarket analysis” supports its position. AT&T *ex parte*, June 28, 2004, at 4. But simply declaring that there is a submarket for bundled local and long distance service does not make it so or establish that regulatory intervention is appropriate here. As Professors Areeda and Hovenkamp have explained, “[s]peaking of submarkets is both superfluous and confusing in an antitrust case, where the courts correctly search for a ‘relevant market’ — that is, a market relevant to the particular issue being litigated * * *.” Areeda & Hovenkamp, *supra*, § 533(c) at 201. “Submarket” assertions notwithstanding, AT&T still needs to demonstrate that it has defined the “relevant market” correctly (i.e., including all those products customers view as substitutes) and explain why the substitutes, and potential substitutes, that we have discussed would not prevent the maintenance of supracompetitive prices for more than two years after such prices were instituted. AT&T has failed completely to do so.

First, it points to market share data that it has calculated for the “bundled market.” As AT&T itself went to great lengths to explain to the Commission when it was seeking relief from classification as a dominant carrier, however, market share by itself – even substantial market share – does not necessarily indicate the existence of market power. Strategic Policy Research, *Disabilities of Continue Asymmetric Regulation of AT&T* 4-6 (1995) (“it is very difficult to draw correct inferences about market power from market share”).

More fundamentally, market share data has no probative value whatever if it is calculated on the basis of an improperly-defined market. As we discuss below, by limiting its “market” to bundled local and long distance wireline services – and ignoring both the stand-alone products and bundles offered by wireless, cable, VoIP, and other emerging competitors – AT&T’s share

¹⁹ For another detailed discussion of how AT&T’s cluster market arguments ignore the legal and economic standards applicable to bundled or cluster markets, see SBC *ex parte*, Dec. 16, 2003, at 4-15.

calculations are meaningless even as a snapshot in time. Given the competitive fervor that is overtaking these markets, moreover, this data is plainly irrelevant to determining whether the BOCs would be able to exert market power for two years after supracompetitive prices were, hypothetically, imposed.

Second, AT&T argues that SBC's bundled prices are lower than SBC's prices for unbundled services. But there is nothing wrong with pricing a bundle lower than the combined price of its separate components, which AT&T does itself (see *supra* note 17), as low prices typically signal the presence of vigorous competition rather than its absence. Indeed, basing regulatory constraints on the existence of low prices raises the very real danger that antitrust principles are being used to subvert the very competition that those principles are designed to protect. Cf. *Brooke Group Ltd. v. Brown & Williamson Tobacco Corp.*, 509 U.S. 209 (1993).

In other words, the key question before the Commission is whether the provider could maintain *supracompetitive* profits, which are achieved by raising prices *above* the competitive level. Merely pointing to the existence of price differentials does not answer that question.

Third, AT&T does not explain why stand-alone offerings of long-distance services would not be sufficient to prevent the maintenance of supracompetitive prices. Many, if not most, consumers still purchase telecommunications services from multiple providers. Declaration of William E. Taylor et al., *supra*, at 11 & n.20. And AT&T itself has explained that not all of its long distance customers have switched to bundled service: "We have introduced lower-priced [long distance] calling plans to which many of our customers have migrated." AT&T 2003 Annual Report, at 4.

Fourth, AT&T never defines the scope of this supposed bundled market or explains how its analysis would apply to the myriad different types of bundles that now exist. As discussed, telecommunications services come in all sorts of bundles. Video services, data services, voice services (local and/or long distance as well as wireline and/or wireless) and entertainment services are combined in a huge variety of options. AT&T provides absolutely no suggestion of how the Commission would apply this standard to determine which types of combinations are within the gerrymandered market and which bundles are outside of it, or how the Commission would analyze the relative prices of all of the different types of bundles. Such a task would not only be extremely complex and result in excessive micro-management, but would also necessitate intrusive and heavy-handed regulation. Of course, AT&T simply sidesteps this messy complexity by creating the erroneous impression that the only relevant bundle is the one that just includes a combination of local and long distance.

Fifth, and most important, even if it were appropriate – and feasible – to consider a market in which long distance services were bundled with other types of services, AT&T has not explained why substitute bundles from wireless, cable, VoIP, IXC/CLECs, and other providers would not prevent SBC from instituting a supracompetitive price increase and maintaining it for two years. The competition for telecommunications customers is intense, and will only escalate in the coming months and years.

A recent article, entitled "Telecom Death Match," reports that one senior telecommunications analyst predicts "a war":

The cable and telecom markets, once clearly defined and with high barriers to entry, have started to merge into one giant, commoditized market. Regulatory hurdles have fallen in tandem with the price of equipment. So instead of having six competitors in the cable market and six competitors in telecom, there will be 12 companies going head to head. *And each competitor will offer the same package of video, Internet and telecom services.*

Barron's, June 21, 2004, at 25 (emphasis added). Leo Hindery, an experienced cable and telecom company executive agrees: "You're on the eve of aggressive bundling practices. * * * It will be a period of almost mutually assured destruction." *Id.*; see also Peter Grant, *Here Comes Cable . . . And It Wants a Big Piece of the Residential Phone Market*, Wall St. J., Sept. 13, 2004, at R4 ("[a] battle royal between cable and telephone companies for the residential phone market is about to sweep the country"); Kawamoto & Charny, *AT&T Chief Refuses*, *supra* (AT&T Chairman describes the competitive landscape for VoIP as "a battle between the cable guys and the Bells"); John Curran, *Study Predicts VoIP Sector Will Grow 100-Fold By 2008*, TR Daily, Aug. 30, 2004 (cable TV system operators are predicted to capture "as much as 10% of the entire U.S. local telephony market by 2008"); Brown & Latour, *Heavy Toll*, *supra* (observing that "[t]he Bells are now losing 4% of their residential lines a year. The trend is worsening as cable companies rush to match the kind of success that Time Warner enjoyed in Maine"); Wireline Section, *Communications Daily*, Apr. 13, 2004 (Standard & Poor's concluding that the growth of VoIP "poses a significant competitive challenge" to BellSouth, SBC and Verizon).

Cable companies are aggressively marketing VoIP bundled with their other products. See *supra* page 4; see also, e.g., Grant, *Here Comes Cable*, *supra* (discussing cable offerings); Sanford Nowlin, *Splitting Lines; Starting Today, Time Warner Will Offer Phone Service To Compete Against SBC*, San Antonio Express-News, July 16, 2004, at 1C (Time Warner launches VoIP to its 660,000 customers in San Antonio); Donny Jackson, *Time Warner Exec Outlines Competitive Landscape*, Telephony Online, June 23, 2004, at http://telephonyonline.com/ar/telecom_time_warner-exec/index.htm (Time Warner's VoIP trial in Portland, Maine, captures 10% of voice customers); *Comcast To Challenge Phone Companies With National Rollout*, *Communications Daily*, May 27, 2004 (Comcast plans to offer VoIP to nearly all of its (now) 21.5 million subscribers by the end of 2005); *Cable MSOs Pick Up VoIP Pace, Shrug Off Vonage*, *Communications Daily*, May 24, 2004 (Time Warner plans to roll out VoIP to all of its divisions by the end of 2004; other cable operators also plan speedy rollout); Michael Stroud, *Cable Guy Whupping Phone Guy*, Wired News, Mar. 11, 2004, at <http://www.wired.com/news/business/0,1367,62616,00.html>.

And, as we have discussed, numerous other competitors are offering VoIP services consisting of bundled local and long distance services. See *supra* page 4; see also Declaration of William E. Taylor et al., *supra*, at 24-27; Jon Van, *RCN Joins Fight for Internet Phone Customers*, Chicago Tribune, Aug. 4, 2004, at C1.

Indeed, the amount (and types) of competitive bundles will only increase as this "war" is conducted over the next several years. The prospect of supracompetitive pricing of either the standalone service or any of these bundles is virtually nil. See, e.g., Grant, *Here Comes Cable*, *supra*; Shawn Young, *All in One: Buying Bundles of Telecom Services Can Make Things Easier and Cheaper for Consumers; The Trick Is Picking the Right Bundle*, Wall St. J., Sept. 13, 2004 at

R6; Nowlin, *Splitting Lines*, *supra* (\$1 price differential between cable voice (local and long distance) bundle and SBC bundle).

With respect to wireless, it is clear that local/long distance wireless bundles can and do substitute for wireline service. See *supra* page 3. The Cellular Telecommunications and Internet Association reports that 7.5 to 8 million consumers now use only wireless telephones.²⁰ An In-Stat/MDR study predicts that by year-end 2004, up to nearly 14 million wireless subscribers will have given up their landline telephone, and by 2008 that number will be up to almost thirty percent of wireless subscribers²¹ – this translates into 57 million subscribers without landline service in four years.²²

Through numerous regulatory actions, the FCC has itself recognized the shifting paradigm from distinct regulatory classifications and treatment for wireline and wireless voice services to inter-modal competition characterized by wireless services acting as a direct substitute for wireline services. This has occurred with respect to: (1) universal service support; (2) section 271 approvals; and (3) wireless local number portability (WLNP). First, the FCC and state regulatory commissions clearly recognize the substitutability of wireless services for traditional wireline services as it has granted, and continues to grant, numerous wireless carriers Eligible Telecom Carrier (ETC) status by virtue of their satisfying an enumerated list of basic local telephone services an ETC must be able to provide.²³ Second, the Commission recognized wireless service as a viable replacement for wireline services in granting several BOC section 271 applications. As a result, wireless service was partially relied upon to successfully demonstrate that competitive alternatives for local exchange services were available to end-users. Finally, the FCC has required wireline carriers to be able to port the existing telephone numbers of their subscribers in order to allow them to wholly switch from their current wireline service provider to a wireless service provider for all voice services while keeping the same telephone number.

²⁰ Peter Brownfield, *Cell Phone Directory Raises Concerns*, FoxNews.Com, May 13, 2004, at <http://www.foxnews.com/story/0,2933,119783,00.html>.

²¹ In-Stat MDR, *Cutting the Cord: Consumer Profiles and Carrier Strategies for Wireless Substitution*, Feb. 2004.

²² *Id.* Another recent study found that 18% of the respondents were willing to “‘cut[] the cord’ and replac[e] their landline altogether” today, even if they had not yet done so. In-Stat/MDR, *Into Thin Air*, *supra*, at 20, 52.

²³ 47 C.F.R. § 54.101. The Commission’s rules require that carriers be able to provide the “supported services” prior to being designated an ETC by the FCC. In the context of USF contribution assessments, the FCC has recognized (in various degrees) in its two most recent orders that one of the important reasons that the existing mechanism is not sustainable is because of the degree of wireless substitution for wireline service stating that “[c]onsistent with these trends, mobile service is becoming a substitute for traditional wireline services such as payphones and second lines to the home.” *In re Federal-State Joint Board on Universal Service*, FCC 02-43, at ¶ 11 (2002). The Commission further stated that “[w]e conclude that a 15 percent interim mobile wireless safe harbor no longer reflects the extent to which mobile wireless consumers utilize their wireless phones for interstate calls, particularly in light of the increased substitution of wireless for traditional wireline service.” *In re Federal-State Joint Board on Universal Service*, FCC 02-329 at ¶ 21 (2002).

Finally, AT&T is simply wrong in asserting that wireline providers are unable to compete with SBC's bundled services. There is continued evidence of entry into the local service markets since the D.C. Circuit's *Triennial Review* decision. XO Communications launched its wholesale local voice services in 36 markets, "covering most of the major metro markets in the U.S." *XO Launches Wholesale Service*, TelephonyOnline.com, Jul. 13, 2004, http://telephonyonline.com/ar/telecom_xo_launches_wholesale/index.htm.²⁴ And Z-Tel has announced that it will continue to serve mass market customers profitably in its key markets by adopting a UNE-L strategy. Z-Tel Technologies Inc., SEC Form 8-K, filed July 27, 2004.²⁵ Moreover, wireline providers can team with providers of other services to create their own competing bundles. For example, AT&T entered into agreements with AT&T Wireless in 2003 and this year with Sprint to resell wireless service in order to offer competitive service bundles. See <http://www.internetnews.com/wireless/article.php/2212581> (*AT&T To Offer Wireless Bundles*) and <http://www.att.com/news/item/0,1847,13067,00.html> (*AT&T To Offer Wireless Services To Consumers And Businesses Nationwide Through Agreement With Sprint*). Likewise, although Qwest is not affiliated with a wireless provider, it offers wireless services both alone and as part of a bundle. See <https://www.qwestwireless.com/index.jsp> and <http://www.qwest.com/newpackages/>.

In sum, AT&T has not proven the existence of a market for bundled services, let alone a separate market for wireline-only bundles of local and long distance voice; but even if it had, it has not come close to demonstrating how SBC could reap more than two years worth of supracompetitive profits despite the fierce competition from other suppliers of bundles – wireless providers, cable telephony and VoIP providers, and IXC's. That is because today's real-world competition – and the even more vigorous fight for customers that is now beginning – makes it impossible to conclude that the BOCs could be dominant in any such submarket.

²⁴ AT&T places great emphasis on the D. C. Circuit's *Triennial Review* decision. Although the D.C. Circuit has vacated and remanded the Commission's unbundling rules, the Commission has recently issued a notice of proposed rulemaking regarding the revision of these rules. The Commission has made clear that its rules will continue to provide competitors with what the Commission determines to be appropriate cost-based non-discriminatory access to a BOC local service components in accordance with the provisions of the 1996 Act.

²⁵ Moreover, although AT&T has announced that it will not pursue additional local residential customers, it will continue serving its existing residential customers and compete aggressively for new business customers and residential customers through its own VoIP offering – CallVantage – which AT&T recently announced it is rolling out in 39 states (see *supra* page 4). That means that AT&T will continue to maintain – and even expand – its infrastructure and, therefore, could again seek new residential wireline customers in addition to its VoIP subscribers if conditions changed. One such change in condition would be an attempt by some market participant to obtain supracompetitive profits. In that circumstance, AT&T would have an incentive to use its infrastructure to reenter the fight for residential customers, and any attempt to obtain supracompetitive profits would be defeated.